

A.I.D. EVALUATION HIGHLIGHTS NO. 17

A.I.D.'S EXPORT PROMOTION PROGRAM IN INDONESIA

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SUMMARY

Indonesia forged a bold policy reform program to boost export growth in the 1980s. In doing so, it switched from being predominantly an oil exporter to becoming a successful exporter of manufactured goods to industrialized countries. The experience of Indonesia demonstrates the importance of policy and regulatory reform to export growth. Indonesia's program of policy reform proved to be much more important than government-subsidized export promotion services in building a strong export sector.

During the 1980s, the Indonesian Government implemented a combination of macroeconomic and sector-specific policies that attracted foreign capital and introduced competition in sectors that had been closed or difficult to penetrate. It also liberalized trade and investment, which accelerated the acquisition of foreign technology, financial and management skills, and the market contacts the country needed to become competitive.

This *Highlights* summarizes the findings of a recent country case study of A.I.D.'s export promotion program in Indonesia. Conducted by the Center for Development Information and Evaluation, the study assesses the range of export promotion services in Indonesia from the perspective of service providers and the firms using such services. The study considers the following factors: the source of services, their use and impact, and the nature of competition in the service market. The study also examines A.I.D.'s role in Indonesia's export drive. During this period, A.I.D.'s Private Sector Development (PSD) project sought to help U.S. investors and Indonesian entrepreneurs overcome constraints that were hampering investment in export activity. The PSD project proved to be far less successful, however, than A.I.D.'s assistance in supporting deregulation. A.I.D. contributed to research and development on policy reform and provided opportunities for management training in the private sector.

The Indonesia study is part of a larger assessment to examine A.I.D. experience with export and investment promotion services worldwide. The assessment's aim is to identify what services exporters actually used, which services made a significant difference to export success, and who provided highly valued services. The study examines the role of export promotion services in shifting from an inward to an outward orientation. It tries to determine whether gaps exist in this service market and whether donors should continue to subsidize, directly or indirectly, such services. The central question in the Indonesian case is whether firm-level assistance is an important adjunct to policy reform.

The study found that

- Policy reform was an important precursor to the development of an indigenous export capability. A.I.D.'s assistance in deregulation throughout the 1980s played a more substantial role in effecting change than did its direct intervention in the export business.
- Government export promotion programs are of some help to exporters at the early stages of foreign-market entry (e.g., buyer contacts, trade fairs, general market information), but are of marginal help later on, when more technical and market-sensitive expertise is needed. The government investment promotion institution had no impact.
- The majority of export firms rely heavily on internal resources and highly interrelated seller-buyer relationships and little on the fee-for-service market for export assistance. Kin, associates, and major buyers provide production, marketing, and financial assistance to entrepreneurs, who still largely avoid fee-based advisory services.

BACKGROUND

Since 1966, when a coup d'état ended years of economic disorder and confused policies, Indonesia has provided a stable, and steadily more favorable, economic policy environment. Per capita income has tripled since 1966. Massive oil revenues during the 1970s allowed for impressive economic expansion during the first 15 years of Indonesia's growth spurt. The decline and collapse of oil prices after 1980, however, destabilized the economy and called into question its dependence on oil exports for financing government spending and capital-intensive investment. Between 1980 and 1988, the share of the oil/natural gas sector plummeted from 75 percent of foreign exchange earnings to 39 percent and from providing nearly 70 percent of government revenue to 41 percent.

This crisis led Indonesia to undertake sweeping economic reforms. A comprehensive tax reform reduced reliance on oil taxes, external financing, and foreign aid. Indonesia also revamped its regulatory structure for trade and investment in order to boost incentives for the private sector. The reforms loosened restrictions on foreign investment and simplified procedures for doing business in Indonesia. The Government eased international trade restrictions by lowering tariffs, liberalizing licensing, and reorganizing the quota system. It was able to administer the reforms incrementally and with little popular backlash, considering the loss of protection and the introduction of new competition. Indonesia had already removed foreign exchange controls in 1970.

As oil prices fell in the early 1980s, the Indonesian export sector faced a number of constraints. Firms had inadequate knowledge of the technical aspects of production and of international markets. Likewise, potential foreign investors lacked information on opportunities in Indonesia. Nevertheless, the rapid growth of Indonesian exports since 1985 shows that these constraints could be overcome. Figure 1 shows the predominance of oil and the relative

insignificance of manufactures in the export mix until the mid-1980s. Figure 2 shows the dramatic growth of manufactures by 1990, following the overhaul of macroeconomic and trade policy. Manufactured exports to the industrial countries tripled to \$6 billion between 1985 and 1990, and manufactures were beginning to challenge oil as a source of export earnings.

This growth in manufactured exports is quickly changing Indonesia's industrial structure. Between 1985 and 1990, shoe exports to member countries of the Organization for Economic Cooperation and Development grew from \$4 million to \$563 million, furniture exports from \$8 million to \$290 million, and textile and clothing exports from \$400 million to \$2 billion. The United States, which takes 30 percent of Indonesia's manufactured exports, has been the country's largest single market, but the export growth shows considerable geographic diversity. Much of the export thrust of the 1980s has been stimulated by inflows of foreign investment. Japan has been the largest source of foreign investment in Indonesia, but since 1986 investment from the newly industrialized countries, such as Taiwan, Korea, Hong Kong, and Singapore, has been rising sharply. The rapid growth of nonoil exports demonstrates that Indonesian firms steadily increased their competence and capacity to produce and market their products. This study surveyed 48 small- and medium-sized Indonesian exporting companies (\$100,000 to \$10 million in annual export sales) and 30 organizations providing services to exporters. The aim was to find out where these firms obtained export or investment-related services and which service providers made a difference.

A.I.D.'S ASSISTANCE APPROACH

During the early 1980s, A.I.D.'s efforts to work with the Indonesian private sector took place in a gloomy investment and export climate of prolonged recession, austerity measures, and declining public investment. Tough foreign equity and divestiture requirements, coupled with a widely perceived inequity in the application of deregulation measures, created further disincentives for foreign investors. Despite higher costs of production, other Asian countries appeared to be more hospitable business environments to U.S. investors who were reluctant to take economic and political risks in sectors other than oil and gas.

During the early 1980s, A.I.D. discussed with the Indonesian Government possible assistance for policy reform and other measures to involve the private sector in Indonesia's development process. In 1982, these discussions resulted in the PSD project, which aimed at positioning A.I.D. as a major donor in assisting the private sector. The key objectives of the PSD project were to provide U.S. professional expertise and to broker U.S./Indonesian business contacts and transactions. A.I.D. funded the project at \$9.6 million for 7 years. The three aims of the PSD project were as follows:

1. *Facilitating foreign private investment.* In the early 1980s, the Indonesian Investment Coordinating Board (BKPM) planned, prioritized, and promoted investment programs. Most important, the BKPM issued the annual Investment Priority List, which specified which business areas were open or closed to foreign investment and which were to receive high or low

Government priority. The PSD project aimed to strengthen the capacity of the BKPM to attract foreign, particularly U.S., investors and to operate effectively as an investment promotion institution.

The BKPM contracted with three Indonesian consulting firms with U.S. business connections. These firms would provide project identification, partner search, proposal preparation, technical assistance on regulatory issues, and government facilitation. A.I.D. expected that the three consulting companies would develop long-term relationships with U.S. clients for repeat business.

2. *Management Training.* A.I.D. believed that Indonesia's business community lacked the necessary management skills to take advantage of new opportunities. Few entrepreneurs or managers possessed modern management education or had the chance to visit the United States. The PSD project provided training for the private sector and created business ties between the United States and Indonesia. The project included a \$500,000 grant for the Ministry of Finance to fund short-term, mid-career, and advanced training at U.S. business schools. This training program, called the Indonesian Executive Development Fund (IEDF), included training courses, seminars and workshops, and hands-on management internships. Almost 60 firms applied in the first year (1985) and about 35 participants actually traveled.

3. *Special Studies and Consulting Services.* The PSD project included \$4.5 million provision for analyses and technical consultancies aimed at improving Indonesia's business climate. Part of this effort included strengthening institutions responsible for policies and services affecting private-sector activities. The PSD targeted tax reform, capital market development, central banking, and investment instruments, such as venture capital.

FINDINGS

The assessment based its findings on A.I.D.'s experience with export and investment promotion services largely on a survey of 48 export firms and interviews with 30 organizations providing services to local export and investors in export-oriented activities. The intent was to place A.I.D.'s assistance approach in a wider context, which encompassed what services exporters use, which services made a significant difference to export success, and who provided highly valued services.

Both local and foreign firms found a variety of services important to their success. They used both customized services, such as technical assistance for production and sample preparation, and more standardized services, such as country and market information. The survey data suggest that no single service provider can meet all the needs of a local exporter or foreign investor.

Table 1 shows where firms attributed their success in exporting. Foreign investors regarded buyers, suppliers, and partners (both local and foreign), as well as internal resources,

as most critical. Government agencies provided some valuable services for exporters but none for foreign investors. Foreign firms valued most services provided at the beginning of their investment decision-making process (e.g., country identification) and later in the investment promotion process (i.e., preinvestment preparation and startup). Notably, foreign investors gave the Indonesian Government no credit for providing useful investment service.

A.I.D.-financed services, such as assistance to BKPM, the government investment authority, and to private consulting firms, did not have much impact on the assisted group of firms. Overall, A.I.D.-financed intermediaries provided only about 3 percent of the highly valued services received by assisted firms. There was no significant difference between the projected export-growth rates of unassisted and assisted firms. Both are expected to increase exports from 1991 to 1995.

Business partners are critical to the export and investment process, particularly for foreign firms trying to invest in Indonesia. The private sector was key to finding Indonesian partners for foreign investors. Legally, foreign firms need to have local joint-venture partners, and both partners rely on one another for important services. Foreigners supply technical assistance in both production and marketing. Local partners provide government contacts and information on regulations, paperwork, and local conditions.

The private sector, particularly buyers, was critically important to local firms' export success. Through buyers, local firms acquire market information and get assistance with sample preparation and production problems. Contact with buyers provides local exporters with many of the most important services required to export.

Still, for firms new to exporting, the government export promotion agency, the National Agency for Export Development (NAFED), was a key source for buyer contacts.

The private sector—principally buyers and suppliers—is very active in providing important services. Overall, the private sector furnished more than 50 percent of local firms' export services. The public sector supplied only 12 percent. What this survey suggests is that government agencies can be helpful in providing information services and in providing buyer contacts. Technical assistance, sample preparation, and market information are best left to buyers and partners.

Which service providers have been most effective?

Interested buyer as supplier. Joint ventures that typify Asian investments in Indonesia are perhaps the most effective vehicles for export assistance. These close-knit relationships often contain the full range of services needed to develop a potential export product. Japanese partnerships, for example, place Japanese technicians and managers within Indonesian firms to ensure quality and timely delivery of goods to the Japanese marketplace. Beyond this, the Japanese sponsor trade missions and fairs for Indonesian goods and training programs stressing

quality control and Japanese management techniques. The number of such broad spectrum arrangements is unknown, but clearly they account for a major part of Indonesia's trade with Japan in manufactured goods.

Japan also serves as an interesting model of buyer dominance and of public and private sector cooperation in pursuit of export enhancement. The key players in the Japanese approach are the Economic Section of the Embassy of Japan, the Japan International Cooperation Agency, the Japan External Trade Organization, the Indonesia Export Training Center, and Japanese importers. Throughout, the emphasis is on creating dependency on the Japanese market or markets beyond, but through Japanese channels. Several other countries—notably the Netherlands and Germany—have also developed close interaction between aid and trade policies. These approaches are based on the assumption that promotion of foreign investment in Indonesia and increased Indonesian exports to the home country promote the donor country's interests. However, there is no clear evidence on the quantitative effect of such links on exports from the donor country.

Government agencies. Exporters have benefited in a limited way from services of government agencies, particularly the Ministry of Trade. Indonesia's Ministry of Trade is attempting to move from a largely regulatory role to one that stresses promotion and facilitation of trade. With donor help, the Ministry is trying to raise the professional standards of its personnel and to rethink the effectiveness of the Ministry's operational programs. A.I.D.'s Young Professionals Program, for example, is a Ministrywide effort to provide on-the-job training to mid-level staff through lectures and workshops. The Ministry of Trade's trade promotion agency NAFED, for example, has targeted small- and medium-size businesses as beneficiaries of its services. NAFED is also finding a niche in arranging trade missions and trade fairs for relatively new-to-export companies. It also facilitates foreign-buyer contact with appropriate local producers. While its overseas network has not been very effective, it has had some success at supporting and coordinating sales missions abroad, especially in Japan, Germany, and the Netherlands. Sales missions to the United States, in contrast, are rare and poorly supported.

Other. Only a few consulting firms with an expatriate element have made significant profits in brokering the occasional, large investment transaction for foreign firms. Small Indonesian export firms continue to be reluctant to pay for consultant services, nor do they represent a lucrative clientele for big firms with high overhead. Producer associations appear to lack the technical capacity to be key resources for their membership. At their best, they provide members with information on production technology and market conditions, but many foreign buyers consider them weak and constrained by bureaucracy.

Have A.I.D.-assisted providers been effective?

A.I.D.'s PSD project produced mixed results. Overall, its success was compromised by the role of the BKPM as a regulator of foreign investment. The BKPM was never staffed or organized to deal effectively with the private sector in an investment or export promotion role.

The consulting firms contracted under the PSD performed poorly and their efforts were mostly ineffective. They were hampered by an inability to deal smoothly with the BKPM, poor execution of some of the project profiles, less-than-adequate A.I.D. contract administration, and an apparent lack of export promotion expertise. Their main area of expertise was the brokering of U.S. investments in the traditional energy sector, not joint ventures in nontraditional exports.

In 1984, after considerable delay, the BKPM awarded three contracts to consulting firms for preparing project profiles and for providing consultant assistance to both Indonesian entrepreneurs and U.S. investors. The projects were in agribusiness and light manufacturing. The firms were (1) to prepare project investment profiles; (2) to identify promising companies for investment; (3) to provide promotional services such as direct mail, leaflets, and business forums; (4) to assist in the preparation of investment applications; and (5) to undertake partner searches.

The firms were unsuccessful in preparing project profiles. They produced five profiles, but the profiles generated little investor interest. Although this failure may have reflected the low quality of the firms' analyses, it is more likely that the BKPM selected project profiles according to government policy views rather than expectations of economic viability. Also, BKPM did not market business opportunities aggressively enough, and, in 1986, the project dropped the profiles altogether.

Providing limited amounts of free consulting time to Indonesian entrepreneurs and to U.S. firms also yielded few results. Indonesian businessmen were unaccustomed to using consulting firms, and free time did not overcome this reluctance. The traditional Indonesian form of purchasing promotional services was through advice linked to a commission if the transaction was successful. The consulting firms considered 250 inquiries, of which 20 U.S. and 34 Indonesian companies received free consultant time. Out of all this activity, only four companies prepared applications for BKPM consideration by 1986. Whether any of the four actually resulted in investment is unknown.

In sum, A.I.D.'s investment promotion activity was a failure. This failure stemmed partly from the use of a government institution largely concerned with regulating foreign investment as a vehicle for promoting it, partly from the use of consulting firms as promotional intermediaries, and partly from design flaws.

The management training program was more successful. It has evolved into a worldwide program, the Indonesian Executive Development Fund (IEDF), which has sent more than 150 executives to the United States and which continues today. The visits have included custom-tailored tours of industries and firms, short-term management training, and corporate internships. In addition to individual training, IEDF has facilitated workshops between U.S. counterparts and visiting Indonesian trade delegations. In 1988, Indonesian furniture manufacturers toured the United States to become familiar with import procedures and quality and design issues and to line up contracts. The A.I.D. contractor Pragma Corporation has continued to develop this program on a worldwide basis without A.I.D. funding. Now known as the International Enterprise Development Program, it offers an established program of annual

courses, many of which coincide with trade shows.

A.I.D.'s longest term and broadest impact has been through the studies and technical assistance component of the PSD project, which accounted for 40 percent of its funding. A.I.D. influenced the conceptualization and implementation of various Indonesian deregulation packages. U.S. commercial interests, as well as those of other countries, have reaped the benefits of a more outward- and liberal-market orientation. These studies have helped key policy institutions important to the private sector. For example, A.I.D. assisted the central bank with financial reform, capital-market development, and pension fund administration. The Ministry of Finance used the project funds to simplify tax-collection procedures and improve administration. This benefited private sector organizations by making tax treatment more uniform and reducing the discretionary authority of tax officials. Overall, the studies appear to have strengthened A.I.D.'s relationships with key government agencies, such as the Ministries of Finance and Trade. This has allowed A.I.D. to assist and support reform-minded policy officials and to provide technical help to strengthen Indonesia's institutions.

CONCLUSIONS

The study of export promotion services in Indonesia suggests that the country's efforts to restructure the economy and to liberalize trade and investment were essential to export growth. The private sector responded quickly to these new goals and objectives, both through an inflow of foreign capital and through a restructuring of Indonesian firms.

- A phased trade and investment liberalization and deregulation is an essential precursor to transfers of technology, management expertise, commercial contacts, and finance—all of which spur the development of an indigenous export capability.
- The market for fee-based export promotion services is multiproduct, institutionally differentiated, and competitive. At least as the sector had developed by 1991, there is no evidence of market failure in the provision of such service requiring public action.
- Buyer/seller partnerships, or joint ventures, can be an extremely important factor in promoting export growth. Most export growth in Indonesia is occurring through these partnerships, in which the buyer or foreign partner dominates the supply of production technology, management practices, training, and finance.
- Internal resources and buyer-seller relationships can be more important than externally hired export support services. In Indonesia, the indigenous network of kin and associates provides important counsel and resources to exporters. Fee-based advisory services are still alien to many Indonesian exporters and are developing mainly in response to demands from foreign investors.
- Government-subsidized efforts have some impact at the early stages of market entry and at the level of general information and buyer search facilitation, but they have little value in comparison to private-sector sources. For more specific and technical services, government initiatives have little value in comparison to private sector

sources.

This Evaluation Highlights summarizes the findings from the report Export Promotion in Indonesia, Technical Report No. 6, April 1993 (PN-AAX-263). The Technical Report can be ordered from the DISC, 1611 North Kent Street, Suite 200, Arlington, VA 22209-2111, telephone (703) 351-4006; fax (703) 351-4039.